

IRC §42, Low-Income Housing Credit - Part VII Computing Adjustments

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Note: This guide is current through the publication date. Since changes may have occurred after the publication date that would affect the accuracy of this document, no guarantees are made concerning the technical accuracy after the publication date.

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Chapter 15 Computing Adjustments to the Allowable Annual Credit

Introduction

After auditing the eligible basis, applicable fraction and applicable percentage, the impact of any adjustments on the IRC §42 credit can be determined. In many cases, it will be possible to simply compute the correct allowable credit and compare it to the credit claimed by the taxpayer to determine the adjustment to the credit. For example:

Eligible Basis: \$8,753,000

Applicable Fraction: x .7500

Qualified Basis: \$6,564,750

Applicable Percentage: x 0.0900

IRC §42 Credit per Audit: \$590,828

Credit per Tax Return: \$810,000

Adjustment: (\$219,172)

For other cases, more complex computations are needed to account for:

- Excess Qualified Basis
- Disposition or Acquisition of a Low-Income Building
- Increases in Qualified Basis

As a result, it is highly recommended that adjustments to the credit be calculated using the format presented on Form 8609-A Part II, Computation of Credit.

Topics

This chapter presents a line-by-line discussion of the computation presented in Form 8609-A, Part II, which are relevant to the computation of the correct allowable credit determined during an audit. Each section presents a summary of possible issues related to that line and references to in-depth discussions if clarification is needed.

- Adjustments to Eligible Basis
- Adjustments to the Applicable Fraction
- Qualified Basis
- Disposition or Acquisition of a Low-Income Building During the Taxable Year
- Applicable Percentage
- Allowable Credit Before Adjustments
- Adjustments to the Allowable Credit for Increases to Qualified Basis
- Federal Grants Received After the End of the First Year of the Credit Period
- Accounting for Maximum Qualified Basis
- Summary

Adjustments to Eligible Basis

The building's eligible basis is entered on Form 8609-A, line 1. The examination of eligible basis fundamentally requires consideration of five issues:

- Character of the assets,
- Cost of the assets,
- When the cost was paid or incurred,
- Whether costs were reasonably allocated among the assets, and

- Whether the assets is continuously placed in service during the entire 15-year compliance period.

These topics are discussed in Chapter 8. Based on the examination results, the actual dollar value of assets includable in eligible basis is adjusted as needed. Once the actual dollar value of costs includable in eligible basis is determined, the limitations and adjustments explained in Chapter 9, 10, and 11 should be applied. Adjustments or limitations are applicable for:

- disproportionate standards,
- federal grants,
- IRC §47, Rehabilitation Credit,
- IRC §48, Energy Credit,
- supportive services for the homeless, and
- tax-exempt bonds financing

The last adjustments made to eligible basis are the (1) the limitations on the cost of a community service facility and (2) increase for buildings located in high cost areas.

Adjustments to the Applicable Fraction

The applicable fraction is the percentage of rental units or floor space in a building that qualify as low-income units. The applicable fraction is entered on Form 8609-A, line 2. The examination of the applicable fraction fundamentally requires consideration of three issues:

- whether the units were occupied by an income-qualified household,
- whether the rent for the units is correctly restricted, and
- whether the units are suitable for occupancy.

Based on the examination results, the applicable fraction can be adjusted as needed.

- The applicable fraction is always determined on the last day of the taxable year.
- The applicable fraction is always the lesser of the unit fraction or the floor space fraction.
- A special rule is applied when determining the applicable fraction for the first year of the credit period.
- If the taxpayer acquires and rehabilitates a building qualifying for both the acquisition and rehabilitation credit, the applicable fraction for the substantial rehabilitation credit will be the same as the applicable fraction for the acquisition credit.
- Any reduction in allowable credit for the first year because of the special computation of the applicable fraction is allowable in the eleventh year of the compliance period.

A complete discussion, with examples, is included in Chapter 12

Qualified Basis

The building's qualified basis is computed on Form 8609-A line 3. Once adjustments to eligible basis and the applicable fraction have been made, adjustments and limitations applicable to the qualified basis are considered.

Nonrecourse Debt

A building's qualified basis is reduced by the amount of any nonqualified nonrecourse financing. See Chapter 10 for complete discussion.

Qualified Basis Deemed to be Zero

Qualified Basis may be deemed to be zero. See Chapter 13 for complete discussion.

10-Year Credit Period Has Ended

Generally, no credit is allowable for the 11th through 15th year of the 15-year compliance period. There are two exceptions.

- Under IRC §42(f)(2)(B), any credit not allowable because of the special rule for computing the applicable fraction for the first year of the credit period is allowable in the 11th year of the 15-year compliance period. This remaining credit is accounted for on Form 8609-A, line 17.
- Under IRC §42(f)(3), the taxpayer may claim credit based on the "increase" in qualified basis associated with low-income unit first qualifying for the credit after the end of the first year of the credit period and qualifying for the "2/3 credit," but only to the extent that qualified basis exceeds the qualified basis at the end of the first year of the credit period.

Any decrease in qualified basis after the end of the 10-year credit is subject to the IRC §42(j) credit recapture provisions, even though the taxpayer did not claim credit (other than the exceptions identified above). See Chapter 16.

Disposition or Acquisition of a Low-Income Building During the Taxable Year

Under IRC §42(f)(4), if a low-income building is disposed of during any year for which credit is allowable, the credit shall be allocated between the parties on the basis of the number of days during such year the building was held by each. This adjustment to qualified basis is entered on Form 8609-A, line 4.

As explained in Rev. Rul. 91-38, for purposes of IRC §42(f)(4), the owner who has held the property for the longest period during the month in which a transfer occurs is deemed to have held the property for the entire month and may claim a credit accordingly. In cases in which the transferor and transferee have held the property for the same amount of time during the month of the transfer, the transferor is deemed to have held the property for the entire month and the transferee's ownership of the property is deemed to begin the first day of the following month.

Example 1: Disposition/Acquisition During the Credit Period

A calendar year partnership owning an IRC §42 building disposes of the building on May 25th of the 5th year of the credit period, a 365-day calendar year.

The qualified basis is \$10,000,000. The buyer is also a calendar year partnership.

The seller is deemed to have owned the building for the entire month of May, for a total of 151 days of the 365-day tax year, and the buyer owned the building for the remaining 214 days. The seller will multiply \$10,000,000 by $(151 \div 365)$ to compute the allowable qualified basis of $\$10,000,000 \times 0.4147 = \$4,136,986$.

The seller will be able to claim the credit only if the seller is not subject to the IRC §42(j) recapture provisions. See Chapter 6.

Similarly, the buyer would compute the allowable qualified basis as \$10,000,000 multiplied by $(214 \div 365)$; i.e., $\$10,000,000 \times 0.8563 = \$5,863,014$.

The adjustment described here is only necessary when the partnership owning the low-income building disposes of the building or the partnership is acquiring a building in which it had no previous ownership interest. This adjustment is not made when there is a change in the interests of the partners in the partnership. Instead, the partnership will reflect these changes in the amount of credit passed through to the partners.

Applicable Percentage

The applicable percentage is reported on Form 8609-A, line 5, which is labeled "Credit Percentage." The examination of the applicable percentage requires consideration of the following:

- When the low-income building was placed in service.
- Whether the housing is new or acquired housing.
- Whether the housing is financed with federal funding.

These topics are discussed in Chapter 14. Based on the examination results, the percentage may be adjusted.

- The adjustment will always be based on the applicable percentage for the month the building was placed in service, or, if applicable, the month of the election under IRC §42(b) (1) [A] (ii). The taxpayer cannot make an election under IRC §42(b) (1) [A] (ii) during an audit. Note: Under IRC §42(b)(2), the applicable percentage for non-federally subsidized new buildings placed in service after July 30, 2008, with respect to credit allocations made before January 1, 2014, shall not be less than 9%.
- The applicable percentage can never be adjusted to be greater than designated by the housing agency allocating the credit.
- The applicable percentage is a decimal carried out four places; i.e., 8.54% is 0.0854.

Allowable Credit Before Adjustments

The allowable credit before adjustment is computed on Form 8609-A, line 6, by multiplying the applicable percentage (Line 5) by either:

- The qualified basis on line 3 if the taxpayer owned the building the entire tax year, or
- The qualified basis on line 4 if the taxpayer disposed or acquired the building during the tax year.

Adjustments to the Allowable Credit for Increases in Qualified Basis

If there is an increase to qualified basis under IRC §42(f) (3), then an adjustment is needed to account for the reduced applicable percentage. The adjustment is made on Form 8609-A, lines 7 through 12.

Calculating Increase in Qualified Basis

The increase in qualified basis entered on line 7 is calculated by subtracting the qualified basis determined at the end of the first year of the credit period from the qualified basis reported on line 3. The qualified basis at the end of the first year of the credit period is identified by the taxpayer on Form 8609 Part II as part of the certification for the first year of the credit period.

If the result is zero or less, then there is no increase in qualified basis.

Disposition and Acquisition of a Low-Income Building During the Tax Year

Since the increase to qualified basis is calculated based on the qualified basis before the adjustment to allocate the credit between the seller and buyer of a low-income building on line 4, a similar allocation of the increase in qualified basis must be made between seller and buyer. For line 8, use the same percentages used to determine the allowable qualified basis for line 4.

Two-Thirds Applicable Percentage

Under IRC §42(f) (3) (A), the credit associated with increases in qualified basis is computed using an applicable percentage equal to two-thirds of the applicable percentage that would otherwise apply.

Since the credit computed on line 6 includes the increase in qualified basis multiplied by the applicable percentage, it is necessary to reduce line 6 by the one third that is not allowable. The entry on line 9 is one third of the applicable percentage identified on line 5. The computation is carried out four decimal points. For example, if the applicable percentage is 0.0813, then $0.3333 \times 0.0813 = 0.0271$.

Unallowable Credit

Line 10 is the computation of the credit associated with the increase that is not allowable.
Multiply line 9 by:

- Line 7 if the taxpayer owned the building the entire year, or
- Line 8 if the taxpayer disposed of or acquired the building during the year.

First Year of Increase in Qualified Basis

Under IRC §42(f) (3) (B), when computing the applicable fraction for the increase in qualified basis for the first year of the increase, the special rule for the first year of the credit period in IRC §42(f) (2) is applied; i.e., the sum of the increased applicable fractions determined at the end of each full month of such year divided by 12.

First, determine whether the increase in qualified basis for the year under audit is more than the increase in qualified basis reported for the prior year. Subtract the qualified basis reported on Form 8609-A line 3, for the prior year from the corrected qualified basis computed for the current year to determine the "current year increase."

- If the result is zero or less, there has been no increase in qualified basis and IRC §42(f) (3) is not applicable. The entry on line 11 is zero.
- If the qualified basis reported for the prior year is more than zero, but less than the qualified basis at the end of the first year of the credit period (Form 8609, Part II), then enter the amount on Form 8609-A line 7 on line 11.

Second, if the result is a positive amount, then there is a "current year increase" and IRC §42(f) (3) is applicable.

- Determine the applicable fraction for the first year of the increase. For each month of the taxable year, determine the increase in the applicable fraction above the applicable fraction for the prior year (as reported on Form 8609 line 2). For example, the prior year's applicable fraction was 0.5000 and continued to be the applicable fraction for the first nine months of the next year. The applicable fraction then increased to 0.7500 for October, November and December. The increase is $0.7500 - 0.5000 = 0.2500$ for each month. Add these amounts together and divide by 12. $(0.2500 + 0.2500 + 0.2500) \div 12 = 0.0625$
- Compute the current year increase in qualified basis entitled to the reduced credit by multiplying the applicable fraction determined in (1) by the corrected eligible basis.
- Subtract (2) above from the "current year increase," to determine the portion of the qualified basis included in "current year increase" that is not entitled to the reduced credit because of the IRC §42(f) (3) rule.
- Multiply (3) by two-thirds (0.6666) of the applicable percentage reported on Form 8609-A line 5. The result is the portion of the credit that is not allowable because of the IRC §42(f) (3) rule. Enter this amount on Form 8609-A line 11

Total Adjustment for Increases in Qualified Basis

Line 12 is the total adjustment necessary for increases to qualified basis after the end of the first year of the credit period:

- Line 10 reflects the adjustment for the reduced applicable percentage applied to the entire increase in qualified basis, and
- Line 11 reflects the additional adjustment to the current year increase in qualified basis to account for the months that the units were not low-income units.

Subtract line 12 from line 6, and enter the result on line 13. This is the allowable credit after adjustments for increases in qualified basis.

Federal Grants Received after the End of the First Year of the Credit Period

Line 14 is used by taxpayers to account for federal grants that reduce eligible basis under IRC §42(d) (5) (A), but are included in the eligible basis reported on line 1. Most likely, the grant was received after the end of the first year of the credit period.

For audit purposes, any grants self-reported on line 14 by the taxpayer when filing a tax return should be included as an adjustment to eligible basis on line 1.

Accounting for Maximum Qualified Basis

IRC §42(m)(2) requires state housing agencies to limit the amount of credit allocated to a building so that it does not exceed the amount necessary to ensure the building's financial feasibility as a qualified low-income housing project throughout the credit period. This limit on the credit amount can be accomplished by limiting the qualified basis. The "maximum" qualified basis can be less than, but should not be more than, the actual qualified basis. Maximum qualified basis is documented on Form 8609, line 3a.

If the actual qualified basis equals the maximum qualified basis, then the state agency has allocated credit so that there is a dollar-to-dollar match between the costs included in eligible basis and the costs financed by the credit. Any adjustment to either the eligible basis or applicable fraction will automatically result in a corresponding adjustment to the qualified basis used to compute an adjustment to the credit.

If the actual qualified basis is more than the maximum qualified basis, then the state agency has allocated credit to support only a portion of the assets included in eligible basis.

Two important points:

- The state agency determines the maximum qualified basis based on the final cost certification presented by the taxpayer under IRC §42(m) (2) (C) (i) (III) and the applicable fraction as documented in the extended use agreement.
- The state agency is not required to identify the costs to be included in the maximum qualified basis.

This limit on the allowable annual credit is accounted for on Form 8609-A line 15. The taxpayer must compare the allowable credit as computed on the form to the amount actually allocated on Form 8609 line 1b. The amount claimed cannot exceed the amount allocated.

Example 1: Qualified Basis in Excess of Maximum Qualified Basis

A taxpayer constructs a new 100% low-income building, which, according to the final cost certification presented to the state agency, has an actual eligible basis of \$10,000,000. The actual qualified basis is $\$10,000,000 \times 100\% = \$10,000,000$.

However, the state agency, when allocating the credit, limited the qualified basis to \$9,000,000 and documented the maximum qualified basis on Form 8609 line 3a.

The taxpayer has "excess" qualified basis equaling \$1,000,000, computed as $\$10,000,000 - \$9,000,000$.

Any adjustment to either the eligible basis and/or applicable fraction will result in a decrease in qualified basis. For audit purposes, the decrease in qualified basis must first be applied against the excess qualified basis.

Example 2: Qualified Basis Reduced Below Maximum Qualified Basis

A 100% low-income building has an actual eligible basis of \$10,000,000.

The actual qualified basis is also \$10,000,000.

However, the state agency limited the qualified basis to \$9,000,000 and used a 9% applicable percentage to allocate an annual credit amount of \$810,000.

After making adjustments to both the eligible basis and applicable fraction, an examiner determines that the actual qualified basis is \$8,500,000.

	Per Return	Per Audit
1. Actual Qualified Basis	\$10,000,000	\$8,500,000
2. Applicable Percentage	x 0.0900	x 0.0900
3. Annual Credit Amount (without limitation)	\$900,000	\$765,000
4. Annual Credit Allocated	\$810,000	\$810,000
5. Allowable Credit	\$810,000	\$765,000

The allowable credit is the lesser of line 3, based on actual costs, and line 4, the annual credit allocated. For audit purposes, the adjustment to the allowable credit is calculated based on line 5 above; i.e., $\$810,000 - \$765,000 = \$45,000$.

No adjustment is made to the allowable credit if the actual qualified basis after adjustment is equal to or more than the maximum qualified basis.

Example 3: Qualified Basis Not Reduced Below Maximum Qualified Basis

A 100% low-income building has an actual eligible basis of \$10,000,000.

The actual qualified basis is also \$10,000,000.

However, the state agency limited the qualified basis to \$9,000,000. The state agency used a 9% applicable percentage to allocate an annual credit amount of \$810,000.

After making adjustments to eligible basis, an examiner determines that the actual qualified basis is \$9,500,000. The building's qualified basis is still more than the maximum qualified basis determined by the state agency.

	Per Return	Per Audit
1. Actual Qualified Basis	\$10,000,000	\$9,500,000
2. Applicable Percentage	x 0.0900	x 0.0900
3. Annual Credit Amount (without limitation)	\$900,000	\$855,000
4. Annual Credit Allocated	\$810,000	\$810,000
5. Allowable Credit	\$810,000	\$810,000

The allowable credit is the lesser of line 3, based on actual costs, and line 4, the annual credit allocated. For audit purposes, there is no adjustment to the credit.

Noncompliance with Extended Use Agreement

Even though noncompliance may not result in a reduction of allowable credit, state agencies are expected to enforce the terms of the extended use agreement to the extent a taxpayer does not provide the low-income housing as agreed (see Chapter 5). Alternatively, as discussed in Chapter 14, a state agency may limit the credit amount by lowering the applicable percentage used to compute the credit.

Example 4: Adjustment to Applicable Fraction Reduces Qualified Basis

A 100% low-income building has an actual eligible basis of \$10,000,000.

The actual qualified basis is also \$10,000,000.

However, the state agency limited the qualified basis to \$9,000,000.

The state agency used a 9% applicable percentage to allocate an annual credit amount of \$810,000.

After making adjustments to the applicable fraction, an examiner determines that the actual qualified basis \$9,500,000. The building's qualified basis is still more than the maximum qualified basis determined by the state agency.

	Per Return	Per Audit
1. Eligible Basis	\$10,000,000	\$10,000,000
2. Applicable Fraction	100%	95%
3. Actual Qualified Basis	\$10,000,000	\$9,500,000
4. Applicable Percentage	x 0.0900	x 0.0900
5. Annual Credit Amount (without limitation)	\$900,000	\$855,000
6. Annual Credit Allocated	\$810,000	\$810,000
7. Allowable Credit	\$810,000	\$810,000

As in Example 3, the allowable credit is the lesser of line 5, based on actual costs, and line 6, the annual credit allocated. For audit purposes, there is not adjustment to the credit. In this example, there is no reduction of the allowable credit as long as the applicable fraction is at least 90.00% and no adjustment is made to the actual costs including in eligible basis.

Summary

This chapter focused on computing the corrected allowable annual credit based on adjustments to the eligible basis, applicable fraction, qualified basis, applicable percentage, or any combination of the four factors. Primary points include:

Because the computation of the correct credit amount can be complex, the format presented in Form 8609-A Part II should be followed when computing adjustments to the credit.

IRC §42(m)(2) requires state housing agencies to limit the amount of credit allocated to a building so that it does not exceed the amount necessary to ensure the building's financial feasibility as a qualified low-income housing project throughout the credit period. This limit can be achieved by limiting the qualified basis (maximum qualified basis).

A special computation is needed to account for increases in qualified basis after the end of the first year of the credit period, and a second computation is needed if the increase occurs in the year under audit.

Under IRC §42(f)(2)(B), credit not allowable because of the special rule for computing the applicable fraction for the first year of the credit period is allowable in the 11th year of the 15-year compliance period. The credit for the 11th year is entered on Form 8609-A, line 17.

Under IRC §42(f) (4), if a low-income building is disposed of during any year for which the credit is allowable, the credit is allocated between the parties. This adjustment to qualified basis is entered on Form 8609-A, line 4.

Form 8609-A, line 14, is used by taxpayers to account for federal grants that reduce eligible basis under IRC §42(d) (5) (A). Most likely, the grant was received after the end of the first year of the credit period.

Chapter 16 Credit Recapture

Introduction

Although a taxpayer claims the IRC §42 credit over a ten-year credit period, the taxpayer is required to provide low-income housing in compliance with IRC §42 for fifteen years (the compliance period). In effect, the taxpayer is claiming credit in advance of providing housing during the last five year after the credit period has ended. As a result, one-third of the credit claimed each year during the credit period is associated with providing housing during years 11 through 15 of the compliance period.

The 1/3 portion of the credit claimed each year is commonly referred to as the "accelerated portion" of the credit. The accelerated portion of the credit subject to recapture decreases during the last five years of the compliance period as the taxpayer provides the housing for which the taxpayer claimed the accelerated credit during the credit period.

The recapture of accelerated credit claimed for years prior to the year of an audit is a separate adjustment and is characterized as an addition to the taxpayer tax liability. The disallowance of credit for the year under audit is a reduction of credit available to reduce the taxpayer's federal income tax liability.

A taxpayer may self-report a credit recapture amount using Form 8611, Recapture of Low-Income Housing Credit.

Topics

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- Special Rules
- Noncompliance with IRC §42(h)(5), Nonprofit Set-Aside
- Noncompliance with IRC §42(h)(6), Extended Use Agreement
- Certain Partnerships Treated as the Taxpayer
- Disposition Other than by Foreclosure or Transaction in Lieu of Foreclosure
- Disposition by Foreclosure or Transaction in Lieu of Foreclosure
- Taxpayer Acquires Building During the 15-Year Compliance Period
- Taxpayer Claimed Credit in Excess of Amount Allocated
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Under IRC §42(j)(1), if the qualified basis at the close of any taxable year in the compliance period of any low-income building is less than the building's qualified basis at the close of the

preceding taxable year, then the taxpayer's federal income tax for that taxable year is increased by the credit recapture amount.

Credit Recapture Amount

IRC §42(j) (2) defines the credit recapture amount as equal to the sum of:

- the aggregate decrease in the credits allowed to the taxpayer under IRC §38 for all prior taxable years which would have resulted if the "accelerated portion of the credit" allowable under IRC §42 were not allowed for all prior taxable years with respect to the excess qualified basis described in IRC §42(j)(1), plus
- interest at the overpayment rate established under IRC §6621 on the amount determined under (1) above for each prior taxable year for the period beginning on the due date for filing the return for the prior taxable year involved.

No deduction is allowable for the interest described in (2) above for federal income tax purposes. Computation of the interest portion of the recapture amount is demonstrated in Chapter 17.

In the event there is a reduction in qualified basis such that the remaining qualified basis is equal to or more than the maximum qualified basis identified by the state agency, then there is no reduction of credit or corresponding recapture on the decrease. See Chapter 15.

Note also that the recapture rules do not apply when a credit is disallowed based on an adjustment to the applicable percentage.

Accelerated Portion of Credit

The "accelerated portion of the credit" described in IRC §42(j) (2) is defined in IRC §42(j) (3). The accelerated portion of the credit for each of the prior taxable years with respect to any amount of qualified basis is the difference between the allowable credit under IRC §42 and the credit that would have been allowable if the aggregate credit allowable for the entire compliance period were allowable ratably over 15 years.

Example 1: Accelerated Portion of the Credit

A low-income building received an allocation of credit equaling \$30,000. The aggregate allowable credit for the entire 10-year credit period is \$300,000. Had the \$300,000 been allowable ratably over 15 years, the annual credit would have been $\$300,000 \div 15 = \$20,000$. The accelerated portion of the credit is $\$30,000 - \$20,000 = \$10,000$.

For any year of the 10-year credit period, the accelerated portion of the credit equals one-third of the allowable annual credit. For computation purposes, the fraction is carried out three decimal places (0.333) and is commonly referred to as the recapture rate.

For the first 10 years, the entire accelerated portion of the credit, $5/15$, is subject to recapture. As the taxpayer provides the low-income housing associated with the accelerated portion of the

credit claimed in prior years during the last five years of the compliance period, the accelerated portion of the credit subject to recapture decreases.

If there is a decrease in qualified basis during the 11th year of the compliance period, when the accelerated credit has not been "earned," the recapture rate is still 0.333 or 5/15. Thereafter, the recapture rate decreases 1/15 for every year the taxpayer provides low-income housing after the end of the 10-year credit period. For the last four years of the compliance period, the recapture rate is:

- 4/15 or 0.267 for year 12
- 3/15 or 0.200 for year 13
- 2/15 or 0.133 for year 14
- 1/15 or 0.067 for year 15

Example 2: Decrease in Qualified Basis During the 13th Year of the 15-Year Compliance Period

A low-income building received an allocation of credit based on a qualified basis of \$1,000,000 and an applicable percentage of 0.0900. The allowable annual credit amount is \$90,000.

The tax return for the 13th year of the compliance period is audited and adjustments are made to both the eligible basis and applicable fraction such that the corrected qualified basis was \$750,000. The adjustment to qualified basis is \$250,000

First, determine how much credit is associated with the \$250,000 adjustment by multiplying by the applicable percentage; i.e., $\$250,000 \times 0.0900 = \$22,500$. The recapture rate in year 13 is 3/15 (or 0.200). The accelerated portion of the credit to be recaptured is then calculated as $\$22,500 \times 0.200 = \$4,500$ for each year of the 10-year credit period, or \$45,000 total.

Special Rules

IRC §42(j) (4) provides six special rules for applying the credit recapture provisions.

Tax Benefit Rule

Under IRC §42(j)(4)(A), the taxpayer's tax liability is only increased for the recapture amount computed with respect to credits used to reduce the taxpayer's tax liability in prior years. If the credit was not used to reduce a tax liability, then the carryforwards and carrybacks of the credit under IRC §39 are appropriately adjusted.

This rule is not applicable when calculating the recapture amount for the partnership (or limited liability corporation) owning the IRC §42 project. The maximum recapture amount is computed and attributed to each partner according to the partners' partnership interests.

The tax benefit rule is applied when calculating the recapture amount for taxpayers whose actual tax liability is reduced, usually partners in partnerships owning IRC §42 projects. See Chapter 19 for discussion.

Qualified Basis for Credit Allowed

Under IRC §42(j) (4) (B), only qualified basis for which the taxpayer actually claimed credit is subject to recapture. This rule effectively limits the recapture provisions so that, mathematically, the accelerated credit is not "recaptured" more than once.

Example 1: Multiple Recapture Events

A 100% low-income building received an allocation of IRC §42 credit equal to \$90,000. The applicable percentage is 0.0900 and the qualified basis is \$1,000,000.

The taxpayer began the 10-year credit period in 2001 and claimed \$90,000 in credit each year for 2001, 2002, and 2003. There was a reduction in qualified basis to \$800,000 for 2004. The allowable credit on the \$800,000 qualified basis amount is \$72,000. The accelerated portion of the credit recaptured from 2001, 2002, and 2003 was computed as $(\$90,000 - \$72,000) \times .333 = \$5,994$. The recapture amount (including the interest portion) was \$19,829, which the taxpayer reported when filing its 2004 tax return.

For 2005 and subsequent years the qualified basis was restored to the original \$1,000,000 and the taxpayer claimed \$90,000 in credit for each year 2005 through 2008.

The taxpayer's 2009 tax return is now audited and the qualified basis was determined to be \$650,000. The taxpayer's allowable credit for 2009 is $\$650,000 \times 0.0900 = \$58,500$. The adjustment to the credit is $\$90,000 - \$58,500 = \$31,500$.

To the extent that the accelerated portion of the credit has been recaptured in a taxable year, it cannot be recaptured again. Therefore, for 2001, 2002, 2003 and 2004, the reduction in qualified basis in 2009 takes the 2004 recapture event in account by using the qualified basis claimed by the taxpayer for 2004; i.e., $\$800,000 - \$650,000 = \$150,000$ and the associated credit is \$13,500 computed as $\$150,000 \times 0.0900$. The accelerated portion of the credit recaptured from 2001, 2002, 2003, and 2004 is $\$13,500 \times .333 = \$4,496$.

For 2005, 2006, 2007, and 2008, the reduction in qualified basis is based on the entire reduction in qualified basis between the 2008 and 2009 taxable years; i.e., $\$1,000,000 - \$650,000 = \$350,000$. The associated credit is $\$350,000 \times .0900 = \$31,500$, and the accelerated portion of the disallowed credit to be recaptured is $\$31,500 \times .333 = \$10,490$ for 2005, 2006, 2007, and 2008.

The total recapture "amount" includes interest as determined under IRC §42(j) (2) (B).

As a quick check, the credit previously recaptured from 2001, 2002, 2003, and 2004 added to the amount recaptured for these years in 2009 should equal the credit recaptured from 2005, 2006, 2007 and 2008. In this case, $\$5,994 + \$4,496 = \$10,490$.

Increases to Qualified Basis

Credit associated with increases to qualified basis after the close of the first year of the credit period are claimed over the remaining years of the 15-year compliance period and do not include an "accelerated portion of credit." Therefore, as explained in §42(j) (4) (C), the recapture provisions do not apply to the credit associated with increases to qualified basis under IRC §42(f) (3).

Example 2: Credit Claimed for Increases to Qualified Basis

A 100% low-income building consists of 100 units of identical size. The applicable percentage is 0.0900 and its eligible basis is \$10,000,000. The allocated credit is \$900,000 ($\$10,000,000 \times 0.0900$). At the end of the first year of the credit period, 75 of the units are qualified low-income units and 25 are vacant units that had never been occupied.

Disregarding the special rule for the first year of the credit period and the first year of any increase in qualified basis, the maximum credit the taxpayer may claim during the 10-year credit period is \$825,000, computed as:

- For the \$7,500,000 initial qualified basis: $\$7,500,000 \times 0.0900 = \$675,000$
- For the \$2,500,000 increase in qualified basis after the end of the first year of the credit period: $\$2,500,000 \times 0.0900 \times 2/3 = \$150,000$

For each year, 2 through 7 of the credit period, the taxpayer claimed $\$675,000 + \$150,000 = \$825,000$. Upon audit of the 7th year, however, the qualified basis was reduced from \$10,000,000 to \$7,000,000; i.e., decreased \$3,000,000. To determine the amount of accelerated credit subject to recapture, the decrease in qualified basis must first be reduced by the increase in qualified basis after the end of the first year of the credit period. In this case, $\$3,000,000 - \$2,500,000 = \$500,000$.

The accelerated portion of the credit to be recapture from each of the prior six years is $\$500,000 \times 0.0900 \times .333 = \$14,985$.

Two observations about the example above are appropriate.

First, no attempt is made to match the decrease in qualified basis to specific low-income units. For example, the \$300,000 decrease in qualified basis could be associated with 30 of the 75 units that were qualified low-income units at the end of the first year of the credit period. Alternatively, the \$300,000 may be caused by an adjustment to the building's eligible basis, in which case \$3,000 of the adjustment is associated with each unit.

Second, if the \$300,000 decrease in qualified basis for the 7th year had been less than or equal to the increase in qualified basis after the end of the first year of the credit period, there would have been a reduction in credit allowable for the year, but no recapture of the accelerated portion of credit from prior years.

Tax Credits Not Applied Against the Recapture Amount

Under IRC §42(j)(4)(D), the credit recapture amount (accelerated credit + interest) cannot be offset by any other tax credit; i.e., the credit recapture amount is not treated as a federal income tax against which any federal tax credit can be applied.

Generally, this rule is applied when calculating the recapture amount for taxpayers who actually reduced their tax liability by claiming the credit, usually partners in a partnerships owning a IRC §42 project. See Chapter 19. The rule also has application at the partnership level to prevent taxpayers from offsetting a recapture amount by reducing the credit allowable for the taxable year.

Example 3: Offsetting the Recapture Amount at the Partnership Level

A taxpayer owns a 100% low-income building with a \$120,000 allocation of credit. The taxpayer claimed the full credit each year, for year 1 through 8 of the credit period. At the end of the 9th year, there was a reduction in the qualified basis such that the allowable credit for the year was \$95,000 and the resulting recapture amount was \$54,000.

The taxpayer cannot reduce the allowable credit by the recapture amount (\$95,000 - \$54,000) and claim IRC §42 credit in the amount of \$41,000 for the 9th year.

The taxpayer must separately report the \$95,000 credit allowable for the 9th year and \$54,000 recapture amount.

Casualty Losses

Under IRC §42(j)(4)(E), the recapture provisions do not apply if the reduction in qualified basis results from a casualty loss if the lost qualified basis is restored by reconstruction or replacement within a reasonable time established by the Secretary.

As explained in Chapter 12, a casualty loss for purposes of IRC §42 is the same as defined under IRC §165; i.e., the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual. Property damage is not considered a casualty loss if the damage occurred during normal use, the owner willfully caused the damage or was willfully negligent, or was progressive deterioration such as damage caused by termites.

In CCA 200134006, Chief Counsel clarified that a period of up to two years following the end of the tax year in which the casualty loss occurred is consistent with general replacement principles involving casualties.

If the taxpayer fails to restore or replace the lost qualified basis within a reasonable period, then the recapture provisions are applied for the tax year in which the casualty event occurred. In CCA 200913012, Chief Counsel explained that if the statute of limitations is closed, whether for the casualty event or credits claimed during the restoration period under Rev. Proc. 95-28 or Rev. Proc 2007-54, then the taxpayer's first open taxable year in the compliance period should be treated as the year of the taxpayer's reduction in qualified basis. In other words if a taxpayer represents on its returns that it was entitled to IRC §42 credits in a closed taxable year, then the

taxpayer is stopped under the duty of consistency to deny that it had qualified basis at the end of that taxable year.

A common misunderstanding when accounting for casualty losses is that the recapture relief provisions under IRC §42(j) (4) (E) also allows the taxpayer to claim credit during the period that the qualified basis is reduced and the reconstruction period when the casualty event is not addressed under Rev. Proc. 2007-54. Chief Counsel, in CCA 200913012, explained that IRC §42(j) (4) (E) only provides recapture relief for casualty events; it does not provide for the allowance of credit during the period of time that the building is being restored.

De Minimis Change in Floor Space

IRC §42(j) (4) (F) grants the Secretary (IRS) authority to determine that the credit recapture provisions will not be applied if:

- the credit recapture amount results from a de minimis change in the floor space fraction under IRC §42(c)(1), and
- the building is a qualified low-income building after such change.

If a de minimis change in floor space is discovered as part of an IRS audit, the examiner should contact the IRC §42 program analyst.

Noncompliance with IRC §42(h) (5), Nonprofit Set-Aside

IRC §42(j) Credit Recapture Provision Not Applicable

The IRC §42 credit may be disallowed in its entirety if a taxpayer fails to comply with IRC §42(h) (5) (B) requirements. Failure to comply with IRC §42(h) (5) (B), however, does not, in and of itself, result in an actual (or imputed) decrease in the qualified basis of the building under IRC §42(c) (1). Therefore, the IRC §42(j) credit recapture provisions are not applicable. The taxpayer may claim credit for the taxable year that the violation is corrected (if the taxpayer is otherwise eligible to claim the credit for that taxable year). See CCA 201352009. See Chapter 6 for complete discussion of IRC §42(h) (5).

Noncompliance with IRC §42(h) (6), Extended Use Agreement

IRC §42(j) Credit Recapture Provision Not Applicable

Under IRC §42(h) (6) (A), no credit is allowable under IRC §42 with respect to a building for the taxable year unless an extended low-income housing commitment is in effect as of the end of such taxable year. However, IRC §42(h) (6) (J) provides a correction period should there be a determination that an extended use agreement is not in effect. If the failure is corrected within one year from the date of the determination, then the determination will not apply to any period before such year.

If the taxpayer fails to correct the failure within the one-year correction period, the credit in its entirety can be disallowed. However, the noncompliance does not result in a decrease in qualified basis and the IRC §42 credit recapture provisions are not applicable.

Certain Partnerships Treated as the Taxpayer

IRC §42(j) (5) provides that certain partnerships will be treated as the taxpayer for which the credit is allowable and the credit recapture provisions are applied. In other words, to relieve administrative burdens, the partnership owning the low-income project is treated as a taxable entity and the credit recapture amount is assessed against the partnership rather than the individual partners.

Partnerships to which IRC §42(j) (5) Applies

Under IRC §42(j) (5) (B), any partnership which has 35 or more partners will be treated as the taxpayer for which the credit is allowable unless the partnership elects not to have the rule apply. The election is made on Form 8609, Low-Income Housing Credit Allocation and Certification, line 10b, and is irrevocable.

This rule applies only to the partnership owning the low-income project and only if there are 35 or more partners holding a partnership interest. A husband and wife (and their estates) are treated as one partner. The rule does not apply to partnerships holding partnership interests in partnerships owning low-income project.

Credit Amount Allowed to the Partnership

Under IRC §42(j)(5)(A)(ii), the amount of credit deemed allowed to the partnership is the credit amount the partnership reported and allocated to its partners.

Computing the Credit Recapture Amount

Under IRC §42(j) (5) (A) (iii), the tax benefit rule under IRC §42(j) (4) (A) is not applied. The partnership is treated as if the entire credit claimed was used to reduce its tax liabilities in prior years.

Assessment Against Partnership

Assessment is made directly against the partnership. Contact the IRC §42 program analyst for assistance.

Allocation of Credit Recapture Amount Among Partners

IRC §42(j)(5)(A)(iv) provides that the credit recapture amount assessed against the partnership is income to the partners and will be allocated among the partners of the partnerships in the same manner as the partnership's taxable income for the taxable year.

Disposition Other than by Foreclosure or Transaction in Lieu of Foreclosure

Generally, the disposition of a low-income building (or interest therein) is a credit recapture event. However, under IRC §42(j) (6), the credit recapture provisions are not applied under specific circumstances if the disposition was not by foreclosure or a transaction in lieu of foreclosure.

For partnerships with fewer than 35 partners, and those electing out of the large partnership provisions of IRC §42(j) (5), a partner (taxpayer) may elect to avoid or defer recapture until the taxpayer has, in the aggregate, disposed of more than 33 1/3 percent of the taxpayer's greatest total interest in the qualified low-income building through the partnership at any time. Once dispositions aggregate more than 33 1/3 percent, further deferral is possible for dispositions only if IRC §42(j) (6) is applicable.

Dispositions After July 30, 2008

IRC §42(j) (6) (A), as amended by the Housing and Economic Recovery Act, provides that the credit recapture provisions are not applicable solely by reason of the disposition of a qualified low-income building (or interest therein) if it is reasonably expected that the building will continue to be operated as a qualified low-income building for the remainder of the building's 15-year compliance period.

Instead, the taxpayer disposing of the low-income building (or interest therein) remains subject to the credit recapture provisions should there be any reduction in the building's qualified basis resulting in the recapture of credit under IRC §42(j) (1) for the year of the disposition or any subsequent taxable year.

In addition, the taxpayer disposing of the low-income building (or interest therein) is required to notify the Secretary (IRS) if there is any reduction in qualified basis resulting in the application of the IRC §42(j) credit recapture provisions. See Rev. Proc. 2012-27. The statutory period for the assessment of the credit recapture amount does not expire before the expiration of three years from the date the taxpayer notifies the IRS and such credit recapture amount may be assessed notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.

Dispositions Before July 31, 2008

If a taxpayer disposed of a low-income building (or interest therein) before the 2008 amendment, credit recapture could be avoided if two conditions were met:

- Under former IRC §42(j)(6)(B), the taxpayer reasonably expected that the building would continue to be operated as a qualified low-income building for the remaining years of the 15-year compliance period, and
- Under former IRF §42(j) (6) (A), the taxpayer furnished the IRS with a disposition bond in an amount satisfactory to the Secretary and for the period required by the Secretary.

Bonds were posted with the IRS using Form 8693, Low-Income Housing Credit Disposition Bond, according to instructions provided in Rev. Rul. 90-60. As an alternative, taxpayers were allowed to provide Treasury securities as collateral instead of a bond (see Rev. Proc. 99-11). The bond or collateral remained in effect until 58 months after the end of the 15-year compliance period.

An owner who disposed of a low-income building (or interest therein) on or before July 30, 2008, and timely posted a bond (or collateral) may elect to be treated as if the disposition took place after July 30, 2008, which will result in the cancellation of the bond or return of the collateral funds. Instructions for making the election are included in Rev. Proc. 2008-60.

The IRS can "call a bond" to recapture credit if it subsequently determined that the new owner did not continue to operate the building as a qualified low-income building for the remainder of the compliance period.

Audit Issues and Techniques

If the partnership reported the credit recapture event:

- Was the credit recapture amount reported on Form 8611 correct?
- Did the taxpayer correctly allocate the recapture amount among the partners on Schedules K-1?

If the taxpayer did not report the disposition or credit recapture event:

- Confirm that the disposition was a transaction other than a foreclosure or transaction in lieu of foreclosure by reviewing the sales documents. These documents will also be reviewed to determine whether the taxpayer accurately reported the gain/loss upon disposition.
- Did the partnership have reason to expect that the building would continue to be operated as a qualified low-income building under IRC §42 for the remainder of the 15-year compliance period? If not, the taxpayer is subject to the IRC §42(j) credit recapture provisions. The taxpayer will need to provide evidence that its expectation was reasonable.
- Is the building actually being operated in compliance with IRC §42 requirements at the time of the audit. If not, then the taxpayer is subject to the IRC §42(j) credit recapture provisions. The building's current status as a low-income building in compliance with IRC §42 requirements can be confirmed by contacting the housing agency that made the credit allocation.

Disposition by Foreclosure or Transaction in Lieu of Foreclosure

In the event of a foreclosure (or transaction in lieu of foreclosure), the extended use period is terminated and the building is no longer a qualified low-income building. See IRC §42(h) (6) (E). The termination of the extended use period results in the disallowance of the credit for the year of disposition (unless the new owner enters into a new extended use agreement by the close

of the year of disposition or IRC §42(h) (6) (j) otherwise applies), but does not automatically result in recapture under IRC §42(j). See CCA 201146016.

The disposition is treated like any other disposition of the property. Therefore, the question is whether the taxpayer has a reasonable expectation that the building will continue to be operated as a qualified low-income building for the remainder of the building's 15-year compliance period. This may be more difficult to establish in the event of a foreclosure where the building is seized by a creditor and the extended use period is terminated. See Chapter 5. The taxpayer may not be able to structure the transaction to include continued compliance with IRC §42 requirements, including requiring the new owner to enter into an extended use agreement, as a condition of transferring the title.

Audit Issues: Taxpayer Reports Foreclosure as Recapture Event

If the partnership reports the foreclosure as a recapture event, then the issues are the same as for any other disposition:

- Was the credit recapture amount reported on Form 8611 correct?
- Did the taxpayer correctly allocate the recapture amount among the partners on Schedules K-1?

Audit Issues: Taxpayer Does Not Report Foreclosure as Recapture Event

If the taxpayer did not report the foreclosure as a recapture event, the taxpayer may argue that even though the low-income building was disposed of as a result of a foreclosure, the taxpayer knew with reasonable certainty that the new owner would continue to operate the building in accordance with IRC §42 requirements.

Consider the following fact patterns:

A bank forecloses on an outstanding mortgage on an IRC §42 project during the 10-year credit period and would like to claim the credit for the time period that it owns and operates the housing as a qualifying IRC §42 project. The bank intends to hold the property for only a temporary period and will sell the project when a buyer can be identified.

What influence does the taxpayer have to ensure the bank will sell the project to a party willing to maintain the project in compliance with IRC §42?

HUD forecloses on an outstanding mortgage financing an IRC §42 project and intend to operate the property according to rules governing section 8 or another HUD housing program, which may have rules similar to, but not exactly the same as IRC §42 requirements. In the event the rules conflict, the stricter of the rules will be followed.

Since the IRC §42 rules will not always be the stricter rule (and "stricter" is not defined), it is questionable whether the taxpayer can reasonably expect that the project will continue to be operated in compliance with IRC §42 requirements absent some other assurances.

A state housing agency forecloses on an outstanding mortgage it holds on an IRC §42 project. The agency intended to operate the project as an IRC §42 project until a buyer willing to operate the project in compliance with IRC §42 can be identified.

Audit Issues

- Since the original extended use period was terminated, confirm that the new owner has entered into a new extended use agreement with the state agency and that the agreement is not subordinated to other restrictive covenants governing the use of the property. If not, then the taxpayer is subject to the IRC §42(j) credit recapture provisions.
- Did the partnership have a reasonable expectation that the building would continue to be operated as a qualified low-income building under IRC §42 for the remainder of the 15-year compliance period? If not, the taxpayer is subject to the IRC §42(j) credit recapture provisions. The taxpayer will need to provide evidence that its expectation was reasonable.
- Is the building actually being operated in compliance with IRC §42 requirements at the time of the audit? If not, then the taxpayer is subject to the IRC §42(j) credit recapture provisions. The building's current status as a low-income building in compliance with IRC §42 requirements can be confirmed by contacting the housing agency that made the credit allocation.

Taxpayer Acquires Building During the 15-Year Compliance Period

Regardless of whether the acquisition was through a purchase or foreclosure (or transaction in lieu of foreclosure), a taxpayer acquiring a low-income building, or interest therein, during the 15 year compliance period is entitled to claim any allowable credit if the building is operated in compliance with IRC §42. The credit allowable to the taxpayer for any period after acquisition during the compliance period is the amount of credit which would have been allowable for the period to the prior owner who disposed of the building. See IRC §42(d) (7) (A) (ii).

Taxpayer Claimed Credit in Excess of Amount Allocated

In some cases, a taxpayer may have claimed more than the allowable credit for tax years before the year of the audit.

Example 1: Taxpayer Relies on Carryover Allocation Amount

A taxpayer receives a carryover allocation of credit equaling \$150,000. The low-income building is timely placed in service in 2006 and the taxpayer claims the \$150,000 credit for 2006, 2007 and 2008 before receiving the Form 8609 in January of 2010. However, the state agency did not allocate \$150,000 as identified in the carryover agreement. Instead, the state agency determined that the taxpayer needed only an allocation of \$130,000 to ensure that the project would be financially feasible. The taxpayer claimed the lesser \$130,000 when filing its 2009 and subsequent year returns, but did not amend the prior year returns to correct the overstated credit amount.

Under IRC §42(j)(3)(A), the accelerated portion of the credit is the excess of the credit "allowed" over the allowable credit that would have been allowable for the entire period were the credit allowable ratably of 15 years. To continue the example above:

The taxpayer's 2011 tax return is audited and, based on adjustments to both the eligible basis and applicable fraction; the examiner determines that the correct allowable annual credit is \$120,000. The accelerated portion of the credit to be recaptured from each prior year is computed as:

$$(\$130,000 - \$120,000) \times .333 = \$3,330$$

For 2006, 2007, 2008, the determination of the amount to be recaptured must account for the taxpayer's overstatement of credit.

The allowable credit, after adjustment for the recapture of the accelerated portion of the credit is $\$130,000 - \$3,330 = \$126,670$. The excess of the allowed over the allowable to be recaptured from 2006, 2007, and 2008 is $\$150,000 - \$126,670 = \$23,330$.

For 2009 and 2010, where the credit "allowable" and "allowed" are equal, the accelerated credit to be recaptured is \$3,330.

Taxpayer Continues to Claim Credit After the End of the Credit Period

In some cases, a taxpayer may continue to claim the entire annual credit amount after the end of the credit period, (not the 11th year credit under IRC §42(f) (2) or the 2/3 credit under IRC §42(f) (3)).

Example 1: Taxpayer Incorrectly Determines the Credit Period

A taxpayer receives an allocation of credit equaling \$130,000, timely placed the building in service, and started claiming the credit in 2000. The taxpayer claim credits equaling \$130,000 each taxable year 2000 through 2011.

Under IRC §42(j)(3)(A), the accelerated portion of the credit is the excess of the credit "allowed" over the allowable credit that would have been allowable for the entire period were the credit allowable ratably of 15 years. To continue the example above:

The taxpayer's tax return for 2011, the 12th year of the compliance period, is audited and based on adjustments to both the eligible basis and applicable fraction; the examiner determines that the correct allowable annual credit is \$120,000. Although no credit is allowable, the accelerated portion of the credit to be recaptured from each prior year is computed as:

$$(\$130,000 - \$120,000) \times 4/15 = \$2,667$$

For taxable year 2000 through 2009, the accelerated portion of credit to be recaptured is \$2,667.

The examiner also determines that the 10-year credit period was 2000 through 2009 and that no credit is allowable in 2010 or 2011. The statute of limitation is closed for the 2010 year, so the IRC §42(j) credit recapture provisions are applied. The excess of the allowed over the allowable to be recaptured from 2010, is $\$130,000 - \$0 = \$130,000$. For 2011, the year under audit, the examiner disallows the entire $\$130,000$ credit claimed. Had the 2010 statute of limitation not been closed, the 2010 tax return should have been audited and the entire credit disallowed.

Summary

Because a taxpayer claims the credit over a ten-year credit period, but is required to provide low-income housing for fifteen years, the taxpayer is claiming credit in advance of providing the low-income housing. The 1/3 portion of the credit claimed each year and associated with providing low-income housing in the future is commonly referred to as the "accelerated portion" of the credit.

The "accelerated" portion of the credit claimed in prior years is subject to "recapture" if there is a decrease in qualified basis.

The accelerated portion of the credit subject to recapture decreases during the last five years of the compliance period as the taxpayer provides the housing for which the taxpayer previously claimed the accelerated credit during the credit period.

The recapture amount is equal to the aggregate of accelerated credit recaptured from each prior year plus interest on the recaptured accelerated credit for the period beginning on the due date for filing the return for the prior taxable year involved to the due date for the tax return on which the recapture is reported.

The recapture amount is a separate adjustment and is characterized as an addition to the taxpayer's tax liability.

Special rules are applied when computing the recapture amount:

- Only credit actually used to reduce a tax liability is recaptured; the tax benefit rule is applied. If the credit was not used to reduce a tax liability, then the carryforwards and carrybacks of the credit are appropriately adjusted.
- Only qualified basis for which the taxpayer actually claimed credit is subject to recapture. This rule effectively limits the recapture provisions so that, mathematically, the accelerated credit is not "recaptured" more than once.
- Credit associated with increases to qualified basis after the close of the first year of the credit period is claimed over the remaining years of the 15-year compliance period and is not subject to recapture.
- The recapture amount cannot be offset by any other tax credit; i.e., the recapture amount is not treated as a federal income tax against which any federal tax credit can be applied.
- The recapture provisions do not apply when the reduction in qualified basis results from a casualty loss if the lost qualified basis is restored by reconstruction or replacement within a reasonable time period.

- The IRS has authority to determine that the credit recapture provisions will not be applied under specific circumstances.

Any partnership with 35 or more partners is treated as the taxpayer for which the credit is allowable and the recapture provisions are applied unless the partnership elects not to have the rule apply.

Generally, the disposition of a low-income building (or interest therein) is a credit recapture event. However, under IRC §42(j) (6), the credit recapture provisions are not applied under specific circumstances.

Regardless of whether the acquisition was through a purchase or foreclosure (or transaction in lieu of foreclosure), a taxpayer acquiring a low-income building, or interest therein, during the 15-year compliance period is entitled to claim any allowable credit if the building is operated in compliance with IRC §42 and an enforceable extended use agreement is in place.

The computation of the recapture amount is modified if:

- The taxpayer claimed more than the allowable credit for taxable years subject to recapture, or
- The taxpayer claimed credit for taxable years after the end of the credit period.

A taxpayer may self-report a credit recapture amount using Form 8611, Recapture of Low-Income Housing Credit.

Chapter 17 Examples

Introduction

This chapter presents seven case studies demonstrating how adjustments to the allowable credit are computed and the IRC §42(j) recapture rules are applied.

Topics

- First Year of the Credit Period and Additions to Qualified Basis
- Partial Disallowance of Credit During the 10-Year Credit Period
- Partial Disallowance of Credit in the 11th Year
- Recapture After the End of the 10-Year Credit Period
- Disallowance of Credit in Multi-Year Audits
- Accounting for Prior Recapture Events
- Failure to Meet the Minimum Set-Aside Requirement: One Building Project
- Failure to Meet the Minimum Set-Aside Requirement: Multi-Building Projects
- Summary

Explanations

The case studies have been simplified. Unless otherwise stated:

- All the units are of equal size.
- The applicable percentage is 9%.

First Year of the Credit Period and Additions to Qualified Basis

This example demonstrates the interaction between:

- the rules for computing the credit for the first year of the credit period under IRC §42(f)(2), and
- the rules for additions to qualified basis after the end of the first year of the credit period under IRC §42(f) (3).

Facts

A taxpayer received a credit allocation of \$50,000 for a new 100% IRC §42 low-income building with 50 units. The building was timely placed in service on June 26, 2010. The taxpayer determined that the building's eligible basis was \$555,556. Because the building was placed in service for six full months during the year (July through December), the taxpayer decided that the applicable fraction was 50%. The taxpayer computed the allowable credit for 2010 as:

$$\$555,556 \times 50\% \times 9\% = \$25,000$$

Audit Results

The 2010 tax return was audited and the examiner determined that:

- the taxpayer had included \$95,000 of unallowable costs in eligible basis. The correct eligible basis is $\$555,556 - \$95,500 = \$460,056$.
- the taxpayer had not applied the special rule under IRC §42(f) (2) when computing the applicable fraction for the first year of the credit period. After reviewing the tenant files and applying the special rule, the correct applicable fraction was determined to be 41%.
- 47 of the 50 units (94%) were qualified low-income units at the end of the taxable year and therefore, the taxpayer met the 40-60 minimum set-aside requirement, as elected.

Adjustment to Allowable Credit for 2010

The corrected allowable credit is computed as:

$$\$460,056 \times 41\% \times 9\% = \$16,976$$

Credit Recapture

The IRC §42(j) credit recapture rules are not applicable since 2010 is the first year of the credit period.

Required Filing Checks

The examiner inspected the taxpayer's subsequent year return and determined that the taxpayer had claimed the entire allowable credit based on the overstated eligible basis and without accounting for the three units that were not qualified low-income units at the end of the first year of the credit period (2010). The examiner expanded the audit to include the 2011 return. There are two adjustments:

1. The eligible basis is reduced to \$460,056.
2. The credit is adjusted to account for the 3 units that were first qualified low-income units after the end of the first year of the credit period, resulting in an addition to qualified basis.

First, the examiner computed the qualified basis at the end of the first year of the credit period without applying the special rule under IRC §42(f) (2). The applicable fraction was determined as $47 \div 50 = 94\%$

$$\text{Qualified Basis} = \$460,056 \times 94\% = \$432,253$$

The examiner determined that all the units were qualified low-income units at the end of the 2011 taxable year, and the qualified basis was computed as:

$$\$460,056 \times 100\% = \$460,056$$

There was an increase in qualified basis calculated as:

$$\$460,056 - \$432,253 = \$27,603$$

The increase in qualified basis is then multiplied by one third of the applicable percentage, computed as $0.0900 \times 0.3333 = 0.0300$. This is the portion of the credit associated with the increase in qualified basis that is *not* allowable.

$$\$27,603 \times 0.0300 = \$828$$

Because the special rule under IRC §42(f)(2) also applies to additions to qualified basis, the examiner then determined, based on when the units were first occupied by qualified households, that the applicable fraction for the addition to qualified basis was 4.25%.

The examiner then multiplied the eligible basis by the applicable fraction using the special rule for the first year of the increase, to determine the addition to qualified basis for 2011.

$$\$460,056 \times .0425 = \$19,522$$

An adjustment must be made to account for the increase in qualified basis not allowed because of the first year rule.

Total Addition to Qualified Basis: \$27,603

First Year Addition to Qualified Basis: \$19,552

Addition to Qualified Basis Not Allowed: \$ 8,051

The credit associated with the \$8,051 Addition to Qualified Basis that is not allowable because of the special rule for the first year of the increase is:

$$\$8,051 \times (2/3) (9\%) = \$483$$

Therefore, to account for the addition to qualified basis, the allowable credit must be reduced by $\$828 + \$483 = \$1,311$.

The allowable credit is computed as:

$$(\$460,056)(100\%) (9\%) - \$1,311 = \$42,716$$

Subsequent Years of the Compliance Period

The adjustments to the eligible basis and additions to qualified basis will impact the computation of the credit for all subsequent years. If the taxpayer operates the project in compliance with IRC §42 requirements for the remainder of the 15-year compliance period, then:

- For years 3 through 10 of the credit period the allowable credit will be \$40,577, computed as $\$41,405 - \828 .
- For year 11, the taxpayer may claim the remainder of credit not claimed because of the special rule for the first year of the credit period. The allowable credit is computed as: $(\$460,056)(94\%)(9\%) - \$16,976 = \$21,945$
- For years 11-15, the taxpayer may claim the "2/3 credit" associated with the increase in qualified basis, computed as: $\$27,603 \times (2/3)(9\%) = \$1,656$

Partial Disallowance of Credit During the 10-Year Credit Period

In this example, a portion of the credit claimed in the 7th year of the compliance period is disallowed.

Facts

- A taxpayer received a credit allocation of \$100,000 for the construction of a new low-income building consisting of 100 units.
- The building was placed in service timely and the first year of the credit period was 2006.
- All the units were occupied by qualifying low-income tenants at the end of the first year of the credit period. Based on the special computation of the applicable fraction for the first year of the credit period under IRC §42(f) (2) (A), the taxpayer claimed \$72,000 for 2006.

- The taxpayer claimed the entire \$100,000 credit for 2007 through 2012.

Audit Results

The 2012 tax return was audited and resulted in an adjustment of \$15,000 to the allowable credit based on the disallowance of ineligible costs incorrectly included in eligible basis.

The credit to be recaptured from each prior year is $\$15,000 \times .333 = \$5,000$ for 2007 through 2011.

To apply the IRC §42(j) recapture provisions to the 2006 year, it is necessary to allocate the \$15,000 adjustment between the 1st and 11th year. Since the taxpayer claimed \$72,000 of the \$100,000 credit (72%) in 2006, 72% of the \$15,000 adjustment is associated with the \$72,000 claimed the first year.

$$\$15,000 \times .72 = \$10,800$$

For 2006, the recaptured credit portion of the recapture amount is $\$10,800 \times 0.333 = \$3,596.40$.

The interest portion of the recapture amount is computed as follows:

Tax Year	Interest Computation Period	Credit Recaptured	Recapture Interest	Recapture Amount
2006	April 15, 2007 - April 15, 2013	\$3,596.40	\$1,129.27	\$4,725.67
2007	April 15, 2008 - April 15, 2013	\$5,000.00	\$1,084.00	\$6,084.00
2008	April 15, 2009 - April 15, 2013	\$5,000.00	\$763.50	\$5,763.50
2009	April 15, 2010 - April 15, 2013	\$5,000.00	\$537.50	\$5,537.50
2010	April 15, 2011 - April 15, 2013	\$5,000.00	\$333.50	\$5,333.50
2011	April 15, 2012 - April 15, 2013	\$5,000.00	\$152.00	\$5,152.00
Total		\$28,596.40	\$3,999.77	\$32,596.17

Further, because the disallowance of credit is based on a permanent reduction in eligible basis; the credit allowable in 2013 through 2016 is also reduced from the original \$100,000 allocated by the housing agency to \$85,000.

For 2016, the 11th year of the 15-year compliance period, the allowable credit is based on IRC §42(f) (2) (B); i.e., credit not allowed in the first year of the credit because of the IRC §42(f) (2) (A) special rule is allowable in the 11th year.

- Before the adjustment, the credit allowable in the 11th year was \$28,000, computed as \$100,000 - \$72,000.
- The portion of the \$15,000 adjustment allocated to the 11th year is \$4,200, computed as \$15,000 - \$10,800.
- The allowable credit for 2016 is \$28,000 - \$4,200 = \$23,800

Partial Disallowance of Credit in the 11th Year

In this example, a portion of the credit claimed in the 11th year of the compliance period is disallowed. An allocation of the adjustment must be made between the first and 11th year of the compliance period to account for the special rule under IRC §42(f) (2) for computing the applicable fraction for the first year of the credit period.

Facts

- A taxpayer received a credit allocation of \$100,000 for the construction of a new low-income building consisting of 100 units.
- The building was placed in service timely and the first year of the credit period was 1999.
- All the units were occupied by qualifying low income tenants at the end of the first year of the credit period. Based on the special computation of the applicable fraction for the first year of the credit period under IRC §42(f) (2) (A), the taxpayer claimed \$72,000 in credit.
- The taxpayer claimed the entire \$100,000 credit for years 2000 through 2008.
- For 2009, the taxpayer claimed the remainder credit under IRC §42(f) (2) (B); i.e., \$28,000.

Audit Results

The 2009 tax return was audited and resulted in an adjustment of \$10,000 to the allowable credit. The credit to be recaptured from each prior year is $\$10,000 \times .333 = \$3,330$.

To properly apply the IRC §42(j) recapture provisions to the 1999 year, it is necessary to allocate the \$10,000 adjustment between the 1st and 11th year. Since the taxpayer claimed \$28,000 of the \$100,000 credit (28%) in 2009, 28% of the \$10,000 adjustment is made on the 2009 tax return; i.e., \$2,800 is disallowed.

For purposes of computing the recaptured credit from 1999, \$7,200 of the \$10,000 adjustment is associated with the \$72,000 credit claimed the first year (1999). Therefore:

For 1999, the recaptured credit portion of the recapture amount is:

$$\$7,200 \times 0.333 = \$2,398$$

For 2000 through 2008, the recaptured credit portion of the recapture amount is:

$$\$10,000 \times 0.333 = \$3,330$$

The interest portion of the recapture amount is \$12,767.65, computed as:

Tax Year	Interest Computation Period	Credit Recaptured	Recapture Interest	Recapture Amount
1999	April 15, 2000 - April 15, 2010	\$2,398.00	\$2,072.35	\$4,470.35
2000	April 15, 2001 - April 15, 2010	\$3,330.00	\$2,346.98	\$5,676.98
2001	April 15, 2002 - April 15, 2010	\$3,330.00	\$1,967.36	\$5,297.36
2002	April 15, 2003 - April 15, 2010	\$3,330.00	\$1,673.33	\$5,003.33
2003	April 15, 2004 - April 15, 2010	\$3,330.00	\$1,452.55	\$4,782.55
2004	April 15, 2005 - April 15, 2010	\$3,330.00	\$1,229.44	\$4,559.44
2005	April 15, 2006 - April 15, 2010	\$3,330.00	\$940.73	\$4,270.73
2006	April 15, 2007 - April 15, 2010	\$3,330.00	\$620.71	\$3,950.71
2007	April 15, 2008 - April 15, 2010	\$3,330.00	\$328.34	\$3,658.34
2008	April 15, 2010 - April 15, 2010	\$3,330.00	\$135.86	\$3,465.86
Total		\$32,368.00	\$12,767.65	\$45,135.65

The total recapture amount is \$45,135.65

Recapture After the End of the 10-Year Credit Period

No credit is allowable after the end of the credit period, but a low-income building is deemed to have qualified basis equal to:

Eligible Basis x Applicable Fraction = Qualified Basis

Any decrease in a low-income building's qualified basis from the prior year's qualified basis is a recapture event, even though no credit is allowable in years 11-15 of the compliance period.

The recapture rate, based on the year of the 15-year compliance period, is:

- Years 1-11, $5 \div 15 = .333$
- Year 12, $4 \div 15 = .267$
- Year 13, $3 \div 15 = .200$

- Year 14, $2 \div 15 = .133$
- Year 15, $1 \div 15 = .067$

Facts

- A taxpayer received a credit allocation of \$100,000 for the construction of a new low-income building consisting of 100 units of equal size.
- The building was placed in service timely and the first year of the credit period was 1997.
- For 1997, the taxpayer claimed \$72,000. For each year, 1998 through 2006, the taxpayer claimed the entire \$100,000. For 2007, the taxpayer claimed \$28,000.

The state agency filed a Form 8823 to report that the building was no longer participating in the IRC §42 program, as of June 23, 2009.

Audit Results

The 2009 tax return was audited. Even though the taxpayer did not claim credit for

2009, the IRC §42(j) recapture requirements are applicable. In this case, the qualified basis at the end of 2009 is deemed to be zero and the entire credit claimed in prior years is subject to recapture using the recapture rate applicable to the year of the recapture event.

The recapture rate for 2009, the 13th year, is $3 \div 15 = .200$. For 1997, $\$72,000 \times 20\% = \$14,400$

For 1998 through 2006, $\$100,000 \times 20\% = \$20,000$

For 2007, $\$28,000 \times 20\% = \$5,600$

The recapture amount is \$316,737, computed as:

Tax Year	Interest Computation Period	Credit Recaptured	Recapture Interest	Recapture Amount
1997	April 15, 1998 - April 15, 2010	\$14,400.00	\$17,040.96	\$31,440.96
1998	April 15, 1999 - April 15, 2010	\$20,000.00	\$20,412.00	\$40,412.00
1999	April 15, 2000 - April 15, 2010	\$20,000.00	\$17,284.00	\$37,284.00
2000	April 15, 2001 - April 15, 2010	\$20,000.00	\$14,096.00	\$34,096.00
2001	April 15, 2002 - April 15, 2010	\$20,000.00	\$11,816.00	\$31,816.00
2002	April 15, 2003 - April 15, 2010	\$20,000.00	\$10,050.00	\$30,050.00

2003	April 15, 2004 - April 15, 2010	\$20,000.00	\$8,724.00	\$28,724.00
2004	April 15, 2005 - April 15, 2010	\$20,000.00	\$7,384.00	\$27,384.00
2005	April 15, 2006 - April 15, 2010	\$20,000.00	\$5,650.00	\$25,650.00
2006	April 15, 2007 - April 15, 2010	\$20,000.00	\$3,728.00	\$23,728.00
2007	April 15, 2008 - April 15, 2010	\$5,600.00	\$552.16	\$6,152.16
Total		\$200,000.00	\$116,737.12	\$316,737.12

Disallowance of Credit in Multi-Year Audits

This example demonstrates how the IRC §42(j) recapture rules are applied when noncompliance involves more than one tax year. The accelerated portion of the credit associated with the decrease in allowable credit is recapture just once, in the earliest year open for audit.

Facts

- A taxpayer received a credit allocation of \$100,000 for the construction of a new low-income building consisting of 100 units.
- The building was placed in service timely and the first year of the credit period was 2005, the year after the building was placed in service.
- All the units were occupied by qualifying low-income housings for the entire year of the first year of the credit period, so that the applicable fraction was 100% after applying the IRC §42(f)(2) special rule for computing the application fraction for the first year of the credit period.
- The taxpayer claimed the entire \$100,000 credit for years 2005, 2006, 2007, 2008, 2009, and 2010.

Audit Results

The 2008 tax return was selected for audit. The examiner determined that the taxpayer correctly reported the eligible basis as \$1,111,111. Based on reports of noncompliance submitted by the state agency, the examiner also determined that 25 of the 100 units were not qualified low-income units at the end of the 2008 taxable year.

The corrected allowable credit for 2008 is:

$$\$1,111,111 \times 75\% \times 9\% = \$75,000$$

The audit adjustment to the allowable credit is $\$100,000 - \$75,000 = \$25,000$. The examiner also contacted the state agency and confirmed that none of the noncompliance issues associated with the 25 units in 2008 were corrected until June of 2011. Since the noncompliance existed at the

end of the 2009 and 2010 tax years, the examiner expanded the audit to include the two subsequent years and made the same adjustment; i.e., the disallowance of \$25,000 in credit.

The examiner must also make an adjustment under IRC §42(j) to recapture a portion of the credit claimed in prior years. Using the recapture rate for the 4th year of the credit period (.333), the accelerated portion of the \$25,000 disallowed credit is computed as:

$$\$25,000 \times .333 = \$8,325$$

The recapture amount is computed as:

Tax Year	Interest Computation Period	Credit Recaptured	Recapture Interest	Recapture Amount
2005	April 15, 2006 - April 15, 2009	\$8,325.00	\$1,933.07	\$10,258.07
2006	April 15, 2007 - April 15, 2009	\$8,325.00	\$1,164.67	\$9,489.67
2007	April 15, 2008 - April 15, 2009	\$8,325.00	\$462.87	\$8,787.87
Total		\$24,975.00	\$3,560.60	\$28,535.60

For 2008, there are two separate adjustments. \$25,000 in credit will be disallowed for the current year, and \$28,536 will be recaptured.

For 2009 and 2010, only the \$25,000 adjustment to the allowable credit is needed.

Accounting for Prior Recapture Events

Prior recapture events taken into account will affect the amount of any subsequent credit recaptured, since the accelerated portion of the credit can only be recaptured once.

Facts

- A taxpayer received a credit allocation of \$900,000 for the construction of a new low-income building with an eligible basis of \$10,000,000 and consisting of 100 units.
- The building was placed in service timely in 2001 and the taxpayer elected to begin the credit period in 2002.
- All the units were leased to qualified low-income households during 2001, so the applicable fraction for 2002 using the special rule under IRC §42(f) (2) for the first year of the credit period was 100%.
- The taxpayer claimed the entire \$900,000 credit for years 2002, 2003, 2004.
- For 2005, the taxpayer claimed \$855,000 because 5 units were out of compliance at the end of the 2005 tax year. The taxpayer also correctly reported a recapture amount equal to \$15,000 for each of the prior years 2002, 2003, and 2004, plus interest. The

noncompliance was corrected in 2006 and the taxpayer resumed claiming the entire \$900,000 credit for 2006, 2007, 2008, 2009, and 2010.

Audit Results

The 2009 tax return was selected for audit. The examiner determined that the taxpayer correctly reported the \$10,000,000 eligible basis. The examiner also determined that 25 of the units were not qualified low-income units.

The corrected allowable credit is $\$10,000,000 \times 75\% \times 9\% = \$675,000$

The adjustment to the current year credit is $\$900,000 - \$675,000 = \$225,000$.

The accelerated credit to be recaptured from each prior year is $\$225,000 \times .333 =$

\$74,925. However, the examiner must account for \$15,000 already recaptured from the 2002, 2003, and 2004.

- For 2002, 2003, and 2004, the accelerated credit to be recaptured is $\$74,925 - \$15,000 = \$59,925$.
- For 2005, since the taxpayer did not claim \$45,000 due to the noncompliance, the accelerated credit recaptured is again limited to \$59,925.
- For 2006, 2007, and 2008, the recaptured accelerated credit is the entire \$74,925.

The entire recapture amount is \$584,190, computed as:

Tax Year	Interest Computation Period	Credit Recapture	Recapture Interest	Recapture Amount
2002	April 15, 2003 - April 15, 2010	\$59,925.00	\$30,112.31	\$90,037.31
2003	April 15, 2004 - April 15, 2010	\$59,925.00	\$26,139.29	\$86,064.29
2004	April 15, 2005 - April 15, 2010	\$59,925.00	\$22,124.31	\$82,049.31
2005	April 15, 2006 - April 15, 2010	\$59,925.00	\$16,928.81	\$76,853.81
2006	April 15, 2007 - April 15, 2010	\$74,925.00	\$13,966.02	\$88,891.02
2007	April 15, 2008 - April 15, 2010	\$74,925.00	\$7,387.61	\$82,312.61
2008	April 15, 2009 - April 15, 2010	\$74,925.00	\$3,056.94	\$77,981.94
Total		\$464,475.00	\$119,715.29	\$584,190.29

Failure to Meet the Minimum Set-Aside Requirement: One Building Project

If a taxpayer fails to provide the minimum number of low-income units, the qualified basis is deemed to be zero and no credit is allowable.

Facts

A taxpayer constructed one new 100% IRC §42 low-income building with 100 units. The building was timely placed in service in 2000. The taxpayer determined that the building's eligible basis was \$15,000,000. Based on the taxpayer's certified cost analysis, the state agency determined the allowable credit to be $\$15,000,000 \times 100\% \times 9\% = \$1,350,000$. The taxpayer:

- Elected the 40-60 minimum set-aside under IRC §42(g) (1).
- Elected to begin the credit period in 2001.

The taxpayer claimed the entire credit each year 2001 through 2009.

Audit Results

The 2009 tax year was audited and the examiner determined that 62 of the units could not be documented as qualified low-income units. The applicable fraction was 38%, computed as $(100 - 62) \div 100$. Since the project is comprised of one building, the taxpayer also failed the minimum set-aside

No credit is allowable for 2009 because the taxpayer did not meet the 40% minimum set-aside. In addition, the taxpayer is subject to the recapture provisions since the qualified basis at the end of 2009 is zero and less than the qualified basis at the end of prior taxable year as reported when filing the 2008 tax return. The recapture rate is .333 and the recaptured credit from each prior year is $\$1,350,000 \times .333 = \$449,500$. The recapture amount is \$4,722,897, computed as:

Tax Year	Interest Computation Period	Credit Recaptured	Recapture Interest	Recapture Amount
2001	April 15, 2002 - April 15, 2010	\$449,500.00	\$265,564.60	\$715,064.60
2002	April 15, 2003 - April 15, 2010	\$449,500.00	\$225,873.75	\$675,373.75
2003	April 15, 2004 - April 15, 2010	\$449,500.00	\$196,071.90	\$645,571.90
2004	April 15, 2005 - April 15, 2010	\$449,500.00	\$165,955.40	\$615,455.40
2005	April 15, 2006 - April 15, 2010	\$449,500.00	\$126,983.75	\$576,483.75
2006	April 15, 2007 - April 15, 2010	\$449,500.00	\$83,786.80	\$533,286.80

2007	April 15, 2008 - April 15, 2010	\$449,500.00	\$44,320.70	\$493,820.70
2008	April 15, 2009 - April 15, 2010	\$449,500.00	\$18,339.60	\$467,839.60
Total		\$3,596,000.00	\$1,126,896.50	\$4,722,896.50

Failure to Meet the Minimum Set-Aside Requirement: Multi-Building Projects

A taxpayer may decide to treat each low-income building as a separate project, include all the buildings in a single multi-building project, or group low-income buildings in multiple projects. The taxpayer's decision will be influenced by such factors as when the buildings are placed in service, when the units within the buildings first qualify as low-income units, and whether the buildings are 100% low-income or mixed use.

Facts

- A taxpayer constructed 10 identical four-plexes; i.e., 4 identical units in each building. The buildings are intended to be 100% low-income housing and each building's eligible basis is \$500,000.
- The allowable annual credit for each building is $\$500,000 \times 100\% \times 9\% = \$45,000$. The total allowable credit for the 10 buildings is \$450,000.
- When completing the First-Year Certification, the taxpayer elected to treat buildings 1 through 6 as a project and buildings 7 through 10 as a separate project. The taxpayer elected the 40-60 minimum set-aside for both projects and included an attachment to each Form 8609 to identify which buildings were to be included in each project.
- For 2002, the first year of the credit period, the applicable fraction for each building was 75%, computed using the special rule under IRC §42(f) (2) and the taxpayer claimed \$337,500 in credit. Thereafter, the taxpayer claimed the entire \$450,000 credit each year based on a 100% applicable fraction.

Audit Results

The tax return for 2009, the 8th year of credit period, was audited. When determining whether the units in the six-building project were qualified low-income units, the following facts were established.

- 2 units each in buildings 1, 2, 3, and 4 are qualified units,
- 1 unit in building 5 is a qualified unit,
- All 4 units in building 6 are qualified units.

The examiner next considered whether the project met the minimum set-aside. Altogether there are 24 units in the six-building project and the minimum set-aside is computed as $24 \times 40\% = 9.6$ units. Rounding up to the next whole number, the taxpayer must provide at least 10 low-income units within the six-building project to meet the minimum set-aside. In this project, there are 13 qualifying low-income units and the minimum set-aside is met.

$(4 \times 2) + 1 + 4 = 13$, and the minimum set-aside is met.

The allowable credit for buildings 1, 2, 3, and 4 is computed as:

$$\$500,000 \times 50\% \times 9\% = \$22,500$$

The minimum set-aside requirement is a "project" requirement; i.e., the buildings within the project may have an applicable fraction less than the minimum set-aside percentage and qualify for the credit as long as the minimum set-aside for the entire project is met. The allowable credit for building 5 is computed as:

$$\$500,000 \times 25\% \times 9\% = \$11,250$$

The allowable credit for building 6, where the applicable fraction is 100%, is

$$\$500,000 \times 100\% \times 9\% = \$45,000.$$

The examiner then considers the second project consisting of buildings 7 through 10.

- None of the units in building 7 are qualified units,
- 1 unit in building 8 is a qualified unit,
- 2 units in building 9 are qualified units, and
- 3 units in building 10 are qualified units.

Since there are 16 units in the 4 buildings, the examiner determines that the taxpayer must provide at least 7 low-income units to meet minimum set-aside requirement for the project; i.e. $16 \times 40\% = 6.4$, rounded up to 7. Since there are only 6 qualified

low-income units in the four-building project, no credit is allowable for buildings 7, 8, 9, or 10.

The taxpayer's allowable credit for the 8th year of the credit period is computed as follows based on buildings 1-6.

$$(4)(\$22,500) + \$11,250 + \$45,000 = \$146,250$$

The adjustment to the credit is $\$450,000 - \$146,250 = \$303,750$.

The last consideration is the computation of the recapture amount. The accelerated credit to be recaptured from each prior year is $0.333 \times \$303,750 = \$101,149$. For the first year of the credit period, where the taxpayer claimed 75% of the credit, the recaptured accelerated credit would be $\$101,149 \times 75\% = \$75,862$.

The recapture amount is \$863,871.00, computed as:

Tax Year	Interest Computation Period	Credit Recapture	Recapture Interest	Recapture Amount
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2002	April 15, 2003 - April 15, 2010	\$75,862.00	\$38,120.66	\$113,982.66
2003	April 15, 2004 - April 15, 2010	\$101,149.00	\$44,121.19	\$145,270.19
2004	April 15, 2005 - April 15, 2010	\$101,149.00	\$37,344.21	\$138,493.21
2005	April 15, 2006 - April 15, 2010	\$101,149.00	\$28,574.59	\$129,723.59
2006	April 15, 2007 - April 15, 2010	\$101,149.00	\$18,854.17	\$120,003.17
2007	April 15, 2008 - April 15, 2010	\$101,149.00	\$9,973.29	\$111,122.29
2008	April 15, 2009 - April 15, 2010	\$101,149.00	\$4,126.88	\$105,275.88
Total		\$682,756.00	\$181,115.00	\$863,871.00

Summary

When computing adjustments to the allowable credit and the recapture amount, the computation must account for:

The special rule under IRC §42(f) (2) for computing the applicable fraction for the first year of the credit period. Only the credit claimed is subject to the IRC §42(j) recapture provisions.

Additions to qualified basis after the end of the first year of the credit period, which is not subject to the IRC §42(j) recapture provisions.

Whether the entire annual credit is disallowed or only a portion.

Allocations between the first and eleventh year of the compliance period.

Whether a reduction in qualified basis occurs after the end of the 10-year credit period; i.e., no credit is allowable in years 11-15, but the taxpayer remains subject to the IRC §42(j) recapture provisions.

Prior recapture events, for which the taxpayer correctly accounted, because the accelerated credit cannot be recaptured more than once.

Whether the taxpayer fails to meet the minimum set-aside, in which case no credit is allowable for any low-income building in the project. Alternatively, a low-income building's applicable fraction may be less than the minimum set-aside if the building is part of a multi-building project that, in aggregate, meets the minimum set-aside.

Chapter 18 Report Writing for Partnership Audits

Introduction

Audit reports should contain all the information necessary to ensure a clear understanding of the adjustments and document how the tax liability was computed. Examination reports (unlike workpapers) are legally binding documents and, when executed, serve as the basis for assessment and collection action. Examiners should take all necessary steps to ensure report accuracy. See IRM 4.10.8.

Background Explanation

Since almost all taxpayers owning IRC §42 projects are partnerships, this chapter presents the basic report writing requirements for partnership audits.

Topics

- Audit Reports
- Form 886-A, Explanation of Items
- Form 886-S, Partners' Shares of Income, Deductions and Credits
- Summary

Audit Report

Forms: Non-TEFRA

Form 4605, Examination Changes - Partnerships, Fiduciaries, S Corporations and Interest Charge Domestic International Sales Corporations, is used for presenting the audit results and includes a signature line for the Tax Matters Partner to sign when the case will be closed agreed.

Form 4605-A, Examination Changes - Partnerships, Fiduciaries, S Corporations and Interest Charge Domestic International Sales Corporations (Unagreed and Excepted Agreed) is used when the case will be closed unagreed.

Forms: TEFRA

The audit results can be presented on Form 4605-A, because TEFRA includes separate agreement forms.

Adjustment to Current Year Credit

Any adjustment to the allowable IRC §42 credit for the year under audit will be reflected on Line 5, as an "Other Adjustment." The adjustment's title must identify when the buildings were placed in service to correctly compute the Alternative Minimum Tax at the partner level. The choices in RGS (Report Generating System) are:

- Low-Income Housing Credit in service after 1989 and before 2008, or
- Low-Income Housing Credit in service after 2007.

Recapture Amount

The IRC §42(j) credit recapture amount is a separate adjustment under Line 5 as an "Addition to Tax."

- The full recapture amount should be disclosed; i.e., the recaptured credit and interest combined as a single "recapture amount."
- The maximum recapture amount should be disclosed, without attempting to apply the IRC §42(j) (4) (A) tax benefit rule, which will be applied when the adjustment is made for the taxpaying partner.
- The recapture amount should be assessed for the year of the recapture event.

Under certain circumstances where the taxpayer has failed to restore the IRC §42 project within a reasonable period, the recapture amount will be assessed for the earliest year under audit. See IRC §42(j) (4) (E).

Remarks: Explanations

The "Remarks" section of the report should be used to provide explanations. This section can be used to explain how the IRC §42(j) (4) (A) tax benefit rule will be applied at the partner level. For example:

"The recapture amount shown in this report reflects the maximum possible recapture amount. When determined at the partner level, IRC §42(j)(4)(A) will be applied so that the tax for the taxable year is increased only with respect to the credits allowed by reason of this section which were used to reduce the partner's tax liability. In the case of credits not so used to reduce tax liability, the carryforwards and carrybacks under IRC §39 shall be appropriately adjusted. The interest portion of the recapture amount under IRC §42(j)(2)(B) will be computed using the overpayment rate under IRC §6621(a); i.e., the federal short-term rate determined under subsection (b) plus 3 percentage points (2 percentage points in the case of a corporation). No deduction is allowable for the interest portion of the recapture amount computed under IRC §42(j) (2) (B).

Remarks: Complete Disclosure of Audit Results

The "Remarks" section of the report should also be used to disclose additional audit results to which the taxpayer is agreeing.

For example, the permanent disallowance of specific costs incorrectly included in eligible basis by the taxpayer should be specifically stated so there is no doubt that the eligible basis upon which the credit will be computed in future years has been reduced.

"The taxpayer also agrees to the permanent reduction of eligible basis of the low-income buildings. The corrected eligible basis for each affected building is shown on the attached schedule."

A schedule should be used if the remarks section has insufficient space. For the example above, the schedule should identify each affected low-income building by BIN, and show the eligible basis reported on the tax return, the adjustment, and the corrected eligible basis.

Form 886-A, Explanation of Items

The Form 886-A can be provided to the taxpayer with explanations for the adjustments made to the credit. Alternatively, an examiner may provide copies of issue leadsheets prepared as workpapers during the audit.

Minimum Requirement

At a minimum, the explanation should include a:

- Summary of adjustments to the three components of the credit computation; i.e., the eligible basis, applicable fraction, and applicable percentage. The format and depth of the explanation may vary.
- Computation of the recapture amount, year-by-year, including a separate statement of the credit recaptured and the interest components.

Unagreed Cases

If the case is closed unagreed, the Explanation of Items should be presented in the formal "fact, law, and argument" format.

Form 886-S, Partners' Shares of Income, Deductions and Credits

Form 886-S is used to identify partner level adjustments for each year in which a change is recommended. The form should reflect:

- The corrected allowable credit for each partner.
- The recapture amount, shown as two adjustments. First, the total recaptured credit component under IRC §42(j) (2) (A), and second, the interest component under IRC §42(j) (2) (B).

Summary

This chapter focused on unique aspects of preparing audit reports when making adjustments to the IRC §42 credit.

Adjustments to the credit for the year under audit are reflected as an "Other Adjustment" on Form 4605, line 5.

The current year adjustment's title must identify when the buildings were placed in service to correctly compute the Alternative Minimum Tax at the partner level.

The recapture amount is a separate adjustment on Line 5 as an "Addition to Tax". The full recapture amount should be disclosed; i.e., the recaptured credit and interest combined as a single "recapture amount."

The "Remarks" section of the report should be used to provide explanations and disclose additional audit results to which the taxpayer is agreeing.

Form 886-A should be used to provide the taxpayer with explanations for the adjustments made to the credit. Alternatively, an examiner may provide copies of issue leadsheets prepared as workpapers during the audit. The format and depth of the explanation may vary.

Form 886-S is used to identify partner level adjustments for each year in which a change is recommended. The form should reflect the corrected allowable credit for each partner. The recapture amount should be broken out into its component parts; i.e., the recaptured credit and the interest portions of the recapture amount should be separately stated.